PENDLETON STREET
BUSINESS ADVISORS

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Brexit; what do we know?

It's been less than 24 hours since the citizens of the United Kingdom voted in a historic referendum to leave the Eurozone after 23 years. Much ink will be, and has been spilled writing about this issue, from the pros and cons, to all the commentary related to potential outcomes from the vote. At this point, we have certainty on one thing, British citizens no longer wish to participate in the European Union.

In the coming days and weeks, we expect there to be volatile markets—both up and down, as more news filters in, and clarity is gained.

As investment managers, we seek to understand the ramifications of geopolitical on investments in the near and long term. At this point, we believe it is much too early to make calls on what exactly will happen in the coming months and years as Eurozone bureaucrats and British government officials parse through the innumerable "to-dos" in this divorce.

We thought it would be best to discuss what we do know, and let that be the basis of some thoughts about the future.

1. The U.K. has the 2nd largest economy in the European Union (E.U.) followed only by Germany
2. The U.K. has the 2nd largest trade deficit in the E.U. This means they import more goods/services than they export. This makes them a very important market for exporting countries, like China and Germany. With or without E.U. membership, Germany needs competitive access to the consumers in U.K.
3. The U.K. is the 5th largest economy in the world (U.S., China, Japan, Germany, United Kingdom)
4. The U.K. will have to renegotiate trade agreements with at least 52 countries that the EU has preferential status.
5. The U.K. was never on the Euro currency, and their Bank of England is synonymous with our Federal Reserve Bank. The U.K. makes their own monetary policy decisions, unlike the rest of the Eurozone, whose monetary policy is governed by the European Central Bank.

We have also fielded a few questions from clients today, that we thought we would share, as well as our answers to them.

1. Is this a stock buying opportunity? It's close. As we discussed in our March 30th commentary to end the 1st quarter, we were thinking then that U.S. markets were looking at little overvalued. April and May led to more gains, only to see volatility spike as the Brexit vote neared. As of Friday's market close, we are about 3% below the highs set recently. At a 5% drop (which we may see soon) we will start to get interested in buying stocks. At a 10% or more decline, we think values will be much more attractive than current levels. I'd expect us to put more cash to work at these levels and lower.

2. Could the Brexit start a recession in the U.S.? Very unlikely. While no one is excited about the rate of our economy's growth, the Brexit will mainly effect immigration in the U.K. and trade between the U.K. and E.U. Our country's largest trading partners are Canada and Mexico. Their economies have a much greater effect on ours.

3. When will we know everything we need to know about Brexit? No one knows this. The clear winners so far in the information game will be the news outlets and possibly the attorneys who are most likely lining up the legal challenges to the referendum both in the U.K., and in the E.U.. Make no mistake, there will be numerable and lengthy court battles over the ramifications of this vote.

4. Will this affect our Presidential race? To be determined. We're not political experts, but we're reading a lot about how this was less about trade and finance for the Leave camp, and more about immigration and issues of sovereignty. There is a general anti-establishment feeling that seems to be sweeping the developed world. Remaining a part of the E.U. was seen as agreeing with the establishment in U.K. Donald Trump will most likely seize the spotlight for a bit. He was in Scotland on Friday (impeccable timing?) and made some comments that can be found on the major new agencies. The Clinton camp has been quiet on this so far today, though it's well known that she is a proponent of international trade deals.

5. What isn't being talked about that should be talked about? This one is the most interesting question. The flow of credit between U.K. and the E.U. will be an important thing to watch. Liquidity is at an all-time high, but extending credit is another matter. When credit stops flowing, liquidity is lessened. When liquidity isn't as free flowing, people create it by selling assets that can be turned into cash quickly---like stocks. In the short term, we think liquidity issues in the financial system will cause investors to sell stocks (and possibly bonds) to have access to cash as they need it.

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